TCorp Local Government Services

Economic Commentary – May 2015

New South Wales Treasury Corporation

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The Month in Review

Economic and Market Trends

While unusually cold weather was a major factor explaining surprisingly weak economic growth in the US in the March quarter, disappointingly, there are few signs of a rapid bounce back in growth in the June quarter. US GDP growth in Q1 was revised down closer to 1%, while activity for Q2 is currently on track for a modest 2% outcome. The pace of economic momentum in the US is modest.

That said, the US labour market continues to suggest that growth will recover later this year. While jobs growth did stutter in March, employment increased by a healthy 223,000 in April and the unemployment rate fell to 5.4%. Moreover, jobless claims – a measure of labour market tightness – fell to the lowest level since 2000. This points to further declines in the unemployment in 2015.

Alongside slower US growth, the Chinese economy has also been experiencing weaker growth in 2015. That said, there are signs that growth has troughed, with industrial production growth nudging up to 5.9% y/y in April from 5.6% y/y in March. More importantly, there are more signs that the housing market is beginning to turn the corner.

In Europe, the weaker Euro has resulted in firmer manufacturing activity and a return to growth around the Euro region. Inflation expectations have also lifted. Greece remains problematic, with reports that Government cash levels are running very low, and that little progress being made with its creditors on its debt renegotiations.

After a couple of encouraging months, Australian economic data softened a little over the last month. Retail sales increased by just 0.3% in March, employment fell by 2,900 in April and the NAB Business Survey suggested that overall business conditions dipped to +4 in April from +6 in March. The major disappointment was the Q1 capital expenditure (Capex) survey. The Capex survey suggests investment will continue to decline over the next two years, even in the non-mining sector. The rise in residential construction in Q1 may provide a minor offset. Overall, we interpret these data as a sign that the Australian economy is continuing to grow at a slightly sub-trend pace, rather than slowing further.

Indeed, the Reserve Bank of Australia (RBA) justified its decision to ease monetary policy further at its May Board meeting (to 2.00% from 2.25%) on the basis that growth hasn't accelerated as they had previously expected rather than as a reaction to a slump in growth. Another factor that has provided the scope to cut interest rates is the benign inflation outlook. And with the wage cost index rising by just 2.3% y/y over the past year – the lowest level in the 17 year history of the survey – the RBA will remain confident that the medium-term outlook for inflation remains very much under control.

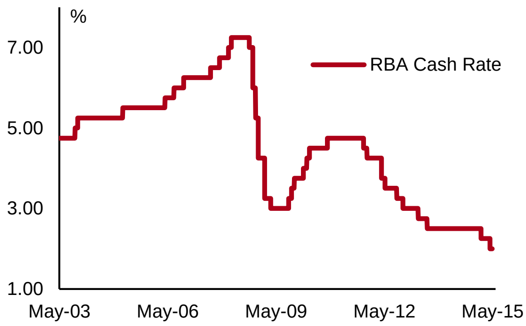
The 2015/16 Australian Commonwealth Budget was also delivered in May. The Budget was centred on providing stimulus to small businesses to help boost growth in the non-mining sectors. The Budget was well received by households, indicated by the increase in consumer sentiment in May. This contrasts with the 2014/15 Budget which was focussed on spending cuts to balance the budget.

The sell-off in global bonds that began in mid-April continued in the first two weeks of May, with much of the impetus emerging from higher European yields. This increase in yields partly reflected higher inflation expectations after the risk of a deflationary spiral receded on the back of higher oil prices. Australian yields initially rose after the RBA removed its easing bias in its communications in May, only to fall back from their peaks as domestic data continued to weaken.

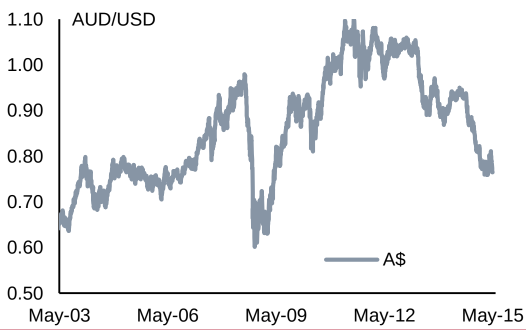
Financial/Economic Data

May 2015

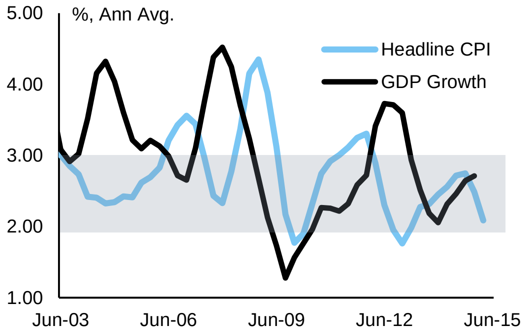
RBA Cash Rate



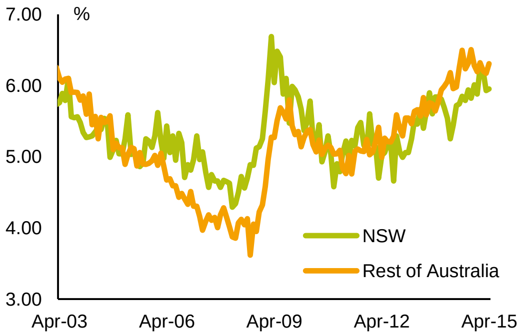
Australia Dollar



Australian Economy



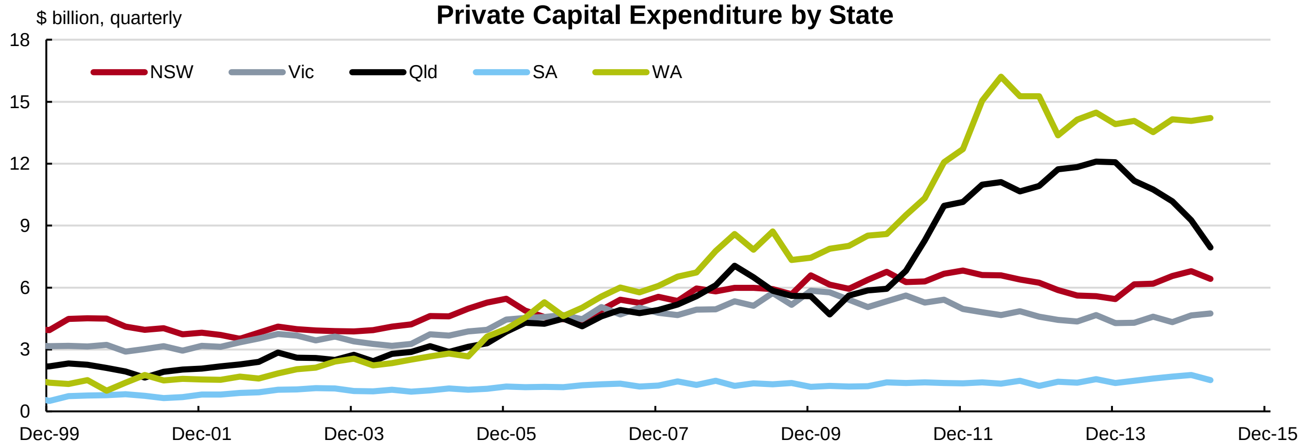
Unemployment Rate



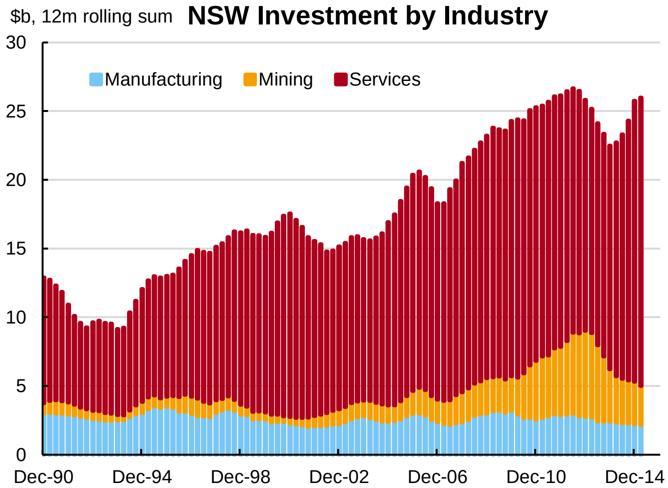
The State of NSW

NSW building permits soar

Private business investment in Australia makes up almost 20% of the economy. Needless to say that it is a key driver of economic growth. However all of the attention over the past five years has been centred on the mining sector. China's insatiable demand for our bulk commodities ensured a steep rise in commodity prices over this period. Now, however, as supply has caught up to demand, it seems the opposite is starting to occur despite China's ongoing demand for Australia's resources. Australia is producing roughly twice the amount of iron ore it was five years ago. And with falling bulk commodity prices, the desire for Australian mining companies to invest in new projects and mines has been substantially reduced.



This has so far been most apparent in Queensland, where most of Australia's coal and gas is produced. The Statistician's Capex survey showed that investment in Queensland fell 15% in Q1, and almost 40% since the peak in 2013. The interesting aspect of the data is the resilience in business investment in Western Australia – where almost all of Australia's iron ore is mined. Nonetheless, investment in the resource-rich States is poised to decline sharply as the growth in global supply of bulk commodities (particularly iron ore) outpaces demand. And while capital expenditure in the non-mining States is not at risk of a precipitous fall, there seems to be little evidence to suggest that there will be a sustained pickup either.



Market Movements and Economic Data

Financial Data	29 May	Monthly change
Cash Rate	2.00%	-0.25 ▼
Corporate Bond Yield*	3.45%	-0.04 ▼
Term Deposit**	2.40%	0.00 –
ASX200	5777	-0.2% ▼
S&P500	2107	1.0% ▲
AUD/USD	0.765	-0.026 ▼

Economic Data***	29 May	Quarterly change
Headline CPI	1.3%	-0.4% ▼
Trimmed Mean CPI	2.3%	0.1% ▲
GDP Growth	2.5%	-0.2% ▼
House Prices	7.0%	-2.4% ▼
Unemployment Rate	6.2%	-0.1% ▼

*A-rated 5-year rate, source: RBA **Average 90-day rate of the five largest banks for $10,000, source: RBA ***National data, y/y, source: ABS, RBA

But based on the chart above, investment in NSW has certainly rebounded from the lows in seen during the GFC. The RBA's reduction in the cash rate since 2011 has supported those interest-sensitive sectors which are most prevalent in the NSW economy. The main beneficiaries so far from lower interest rates have been the retail, construction and real-estate sectors. That said, the increase in investment spending has only brought the level of overall capital expenditure back to the peaks observed in 2010/11. The key question over the next two years is whether businesses in NSW feel confident enough continue investing in their capital. The 2015/16 Commonwealth Budget's accelerated depreciation charges for small businesses may be the kick-start needed to get businesses spending going again, however the outlook for domestic demand remains instrumental in determining the extent to which businesses will want to expand their operations.